

This is an original article written by Philip Loh.

Some insights to supercharge your investment returns

In the course of dealing with the psychological strain resulting from a bear market, many investors are beginning to question their investment methodology and assumptions. Others may be wondering why they keep making the same old investment mistakes they swore never to commit the last time the markets headed down.

In this article, we will explore various interesting insights that may help you improve your investment performance in the years ahead.

To begin with, it is a well-known fact that retail fund investors and direct stock investors have underperformed their respective stock indices by an incredibly wide margin.

The oft-quoted example is the relative performance of the S&P 500, which has risen about 11% p.a. over the last 20 years, versus that of mutual fund investors who have managed to achieve a rise of only 5% p.a. during the same period. Such a wide performance disparity can only be explained by extremely poor market timing.

The following insights are therefore meant to help you understand the many mental hurdles that may prevent you from achieving the investment returns you deserve.

1) Understand the type of investor you are – a trader or a buy and holder

I cannot emphasise enough the importance of understanding the type of investor you are. This realisation will help you to better select the right investment strategies that suit your style.

There are fundamentally two types of investor: the trader, and the buy-and-hold-er (BAHR). Many commentators claim the superiority of one style over another. As for me, both styles are feasible if you can develop a system that can give your investment style an edge.

For a trader, it is important to identify a 'trend' fast so that he can jump on the bandwagon in the early stages of the game. The extra skin in the game will make it easier for him to close his position when the trend turns, empowering him with greater versatility to adjust his exposures when needed.

For a BAHR, value-based and fundamentals analysis should normally form the backbone of his system. His research will provide him with the confidence to hold on to his positions when the market turns against him temporarily.

It is also important to know when to double down and when not to. As a general rule, traders should never double down, especially when they are on leverage while a BAHR should consider it as a viable strategy as long as the exposure is within his risk tolerance.

If your style of investment is more that of a trader, doubling is dangerous because it contradicts your personal dynamics. If the stock continues to turn against you after you average down, you may panic and end up selling out just before the price resumes its long-term trend. This is especially so if you are using some forms of leverage. Your investment time frame in any position is usually shorter and this may work against you in various situations.

As esteemed trader Dennis Gartman put it: “Never, ever, ever, under any circumstance, add to a losing position... not ever, not never! Adding to losing positions is trading's carcinogen; it is trading's driving while intoxicated.”

For traders, this is not a business of buying low and selling high. It is instead a business of buying high and selling higher. In other words, their objective should be to identify trends where there is still some juice left and hop on for a ride.

Meanwhile, for BAHRs, the best bet is to play the value game by buying value and waiting, always bearing in mind Keynes' famous words: “Markets can remain illogical far longer than you can remain solvent.” So be prepared to wait a long time for the crowd to come to your party.

Also, traders should always consider taking profit when there is any, while BAHRs can be extremely patient with winning positions.

Overall, if your portfolio is concentrated, you may need more time to do your monitoring and homework. Always be prepared to reduce your exposure if the conditions that lead you to buy are no longer valid.

Personally, I divide my portfolio into a core buy and hold portion, and a supplementary trading portion. I have my BAH position that I am prepared to hold for years on end and which I may even leave for my children. With this mindset, I wait for the market to realise the value I see in my original positions. For my trading positions, they are usually more numerous and I will prepare to take whatever profits that come my way.

Do more of that which is working for you. This works in life, as well as in investment management. Always do the things that have been proven of greatest merit and remember to stick to them.

2) Understand the mechanism of a bubble.

Once upon a time in a village, a man appeared and announced to the villagers that he would buy monkeys for \$10 each. The villagers, seeing that there were many monkeys around, went out to the forest, and started catching them. The man bought hundreds of them at \$10 each and as supply started to diminish, the villagers stopped catching them.

He then announced that he would now buy them at \$30 each. This spurred the villagers to start catching monkeys again. Soon the supply of monkeys diminished even further and it was difficult to even see a monkey, let alone catch it, so the people stopped catching them again.

The man then announced that he would now buy the monkeys at \$100 each. However, since he had to go to the city on some business, his assistant would now buy them on his behalf.

In the absence of the man, the assistant told the villagers, "Look at all these monkeys in the big cage that the man has amassed. I will sell them to you at \$60 each and when the man returns from the city, you can sell them to him for \$100 each."

So the villagers rounded up all their savings and bought all the monkeys as the assistant suggested. Subsequently they never saw the man or his assistant again. The stock market works in exactly the same way.

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In most markets, there is a small group of elite or dominant players. They are usually professional traders working for large financial institutions like banks and brokers, or ultra-rich individuals with deep pockets.

Now, the bigger the underlying market, the greater the amount of resources needed to create a bubble out of it. Manipulating an entire stock market thus requires the vast resources of large institutions or ultra-rich billionaires.

The elite players know that a bubble feeds on itself, and are always ready to create one when conditions are right. Indeed, the playing field of large institutions has to be enormous, often that of an entire country, for them to be truly profitable. For example, George Soros was rumoured to have cornered the British pound and Thai baht some years back. In fact, the Thai baht episode is widely recognised as the start of a chain of events that spiralled into the Asian currency crisis.

The first criterion for making money from bubble creation is that there must be a lot of cash on the sidelines. If there is no ready cash on the sidelines to feed the bubble, it will have to come from external sources which can be more difficult to engineer. The money on the sideline is mostly the cash savings of retail investors.

The elite group meanwhile provides the seed money to initiate a bubble, grabbing a big bunch of the asset class at good prices at the same time. They can act aggressively from time to time to ensure that the bubble created remains intact. For example, they can ensure that the STI closes at 3,500.1 points rather than 3,499.9 points for the day.

Once individual retail players have depleted their cash reserve, it will then be time for the elite group to cash out. This may be the time when it becomes psychologically difficult to push prices any higher in the near term. For example, the Japanese equity market had a good run in 2005, followed by a period of distribution in the ensuing two years.

From time of the tulip bulb mania in 17th century Holland to the 18th century South Sea Bubble in England, till the Internet bubble of the late 1990s, speculative financial bubbles have always remain an integrated part of the financial markets.

3) Understand that this is a “big-fish-eat-small-fish”, and “small-fish-eat-shrimp” world

The big boys in the stock market are the investment banks and hedge funds. Mutual fund managers may be big players, but their mandates require them to stay largely fully invested and they are thus more of price-takers than price-makers.

Now, the financial statements of the investment banks show that they are usually generating excellent returns from trading activities. Is it any wonder that the top CEOs on Wall Street are mostly former star traders? Profits from trading desks often constitute more than 50 percent of the total earnings of an investment bank. They outperform the general market by tens of billions of dollars every year. If the investment banks are collectively the winners, then who are the collective losers?

It is important to realise that large financial institutions have a strong influence on commentaries made in the media. When a media outlet needs a comment on a piece of economic news, it is natural for them to seek the expert opinion of analysts from large financial institutions or banks.

And when an institution wants to influence the thinking of a market in a certain way, especially when it has huge positions or interests in them, it may publish a report stating that this or that asset price may surge or plunge due to certain arguments that appear logical and are therefore convincing.

Note too that often, when the stock market ends higher for the day, the media will attribute it to some economic news and events that happened during the day. When the stock market ends lower for the day, the drop is also attributed to the same news and events that caused the rise.

In actual fact, the day-to-day fluctuations of the market are just noise and they are caused by “money flow” more than anything else. The only reason the market is going up may be that some investors or hedge funds are buying, and the reason they drop is that someone is selling. It is that simple.

Investors should therefore do their homework and make up their own mind, so as not to be easily influenced. For most investors, thinking like a small “fish” will allow you to create a winning mindset. As a small investor, your best chance of winning is to run your little party and wait for the crowd to join you.

Meanwhile, unless you are a day trader who can exit positions within the day or week, joining other people’s parties indiscriminately may be financial suicide when the rug is pulled from under your feet.

Remember, if you are a “shark”, play like a “shark”. If you are an “*ikan bilis*”, thinking and playing like one will ensure your survival till the day you attain your “shark” status. Happy investing!